momentum

investments

The Macro Research Desk

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Downgrade risk of South Africa's sovereign debt

Ratings pronouncements from S&P and Fitch are imminent

South Africa's sovereign debt is rated investment grade (IG) by all three main rating agencies (see table 1). While S&P Global Ratings (S&P) and Fitch Ratings Inc. (Fitch) now have SA's foreign currency government debt rating at the lowest rung of IG (BBB-),

Moody's Investors Service (Moody's) recently affirmed SA's sovereign rating at one notch higher within IG (Baa2). Moody's local currency rating of SA government debt is in line with its foreign currency rating, but S&P (two notches higher) and Fitch (one notch higher) have higher local than foreign currency ratings attached to the SA sovereign debt. S&P is scheduled to release the results of its latest rating review of SA debt on 3 June, with Fitch providing its latest pronouncement around the same time. While negative ratings action cannot be ruled out in June (particularly on the Fitch ratings outlook), Momentum Investments thinks it is more likely that both ratings agencies will want to first assess fiscal realities in the Medium-term Budget in October 2016, as well as developments on the local growth front, before taking the big step of classifying SA's debt as junk.

Table 1: South Africa's sovereign debt ratings

Long-term rating	S&P	Fitch	Moody's
Investment grade	A-	A-	A3
	BBB+	BBB+	Baa1
	BBB	BBB	Baa2
	BBB-	BBB-	Baa3
Sub-investment grade	BB+	BB+	Ba1
Outlook	Negative	Stable	Negative

Local currency rating
Foreign currency rating

Source: S&P, Fitch, Moody's, Momentum Investments

Fitch downgraded SA's local and foreign currency debt by one notch in December 2015, concomitantly attaching a neutral outlook to the ratings, while S&P affirmed both its ratings in December, but cut the outlooks to negative. Moody's retained its negative outlook on SA's debt on 6 May, after shifting it lower from a stable ranking in December 2015. Typically for ratings on a negative outlook, the absence of an improvement in debt metrics would lead to a ratings downgrade within 12 to 24 months.

This would imply that the next negative respective ratings actions would be a downgrade by S&P (to junk on foreign currency and BBB IG on local currency), a downgrade by Moody's of the foreign and local currency ratings to the lowest level of IG (Baa3) and a cut in the ratings outlooks by Fitch. While S&P and

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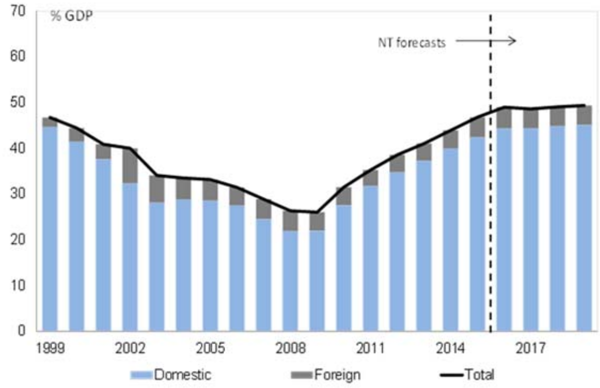
Severe currency weakness is a significant risk to countries that have high levels of foreign currency-denominated debt, as this debt could skyrocket so much that these countries become unable to service their debt and are then forced to either default or approach the International Monetary Fund for bailouts. This is not the case for SA – it has very little foreign currency-denominated debt (below 10%
– see chart 2) and thus the quantum of its overall outstanding government debt has not risen meaningfully due to the recent sharp rand weakness. Of course, bond yields have gone up substantially in SA since January 2015 and this is negatively affecting the cost of servicing debt in SA (although only marginally, as 64% of SA's debt is fixed rate).

Chart 2: Less than 10% of SA's outstanding sovereign debt is in foreign currency



Source: RMB Morgan Stanley

How probable are further ratings downgrades?

When Fitch and S&P downgraded SA's ratings and outlook, respectively, in December 2015, they justified this on the basis of lower potential growth, rising debt/gross domestic product levels, worries about the potential rise in contingent liabilities from weak state-owned enterprises' balance sheets for government's debt profile, as well as the financing of the structural current account deficit. They also noted that policy deliberations (national minimum wage debate, plans for land reform, delays to the mineral resources bill and the initial visa restrictions) had weakened business and investor confidence, further threatening the outlook for longer-term growth.

Since then, the growth outlook has deteriorated further, putting more pressure on fiscal and debt metrics (particularly relative to SA's BBB- ratings peer group). Furthermore, one of the historical cornerstones of SA's investment-grade rating has been its highly regarded institutional framework, including Treasury and the South African Reserve Bank (SARB).

'Nenegate' (during which SA's Finance Ministers were replaced twice in four days in December 2015) and recent speculation about current Finance Minister Gordhan's imminent arrest, related to allegations of his involvement with setting up a previous covert investigation unit within the South African Revenue Service, have introduced worries that these institutions are no longer deemed untouchable by politicians and could be less independent institutions than previously perceived.

The 24 February 2016 National Budget seemingly left the rating agencies satisfied for now that government remains committed to its fiscal consolidation and expenditure ceiling targets. However, current expenditure will still have to be curtailed meaningfully to protect the expenditure ceiling in the longer run (which is closely linked to long-term economic growth projections), while leaving vital capital expenditure relatively unscathed. Revenue-enhancing tax proposals will also have to be part of the mix to bring down the deficit in the coming years.

If the budgetary outcomes disappoint by the time the Medium-term Budget is received in October 2016, S&P will likely implement a ratings downgrade to the sub-investment grade level in early December, with Fitch following in time. Key metrics to watch include government's ability to constrain the burgeoning civil servant wage bill and any further downgrades to already-weak growth forecasts, which would dampen revenue prospects in the absence of further revenue proposals. The recent proposed amendments to the mining charter, the passing of the land expropriation bill by parliament and labour reforms remaining stuck at NEDLAC bode ill for S&P's assessment of structural reform momentum in SA and the ability for SA to generate a higher growth path in the medium to longer term.

Effect on the SA economy

As has already been very evident since December last year, the threat of negative ratings action has a significantly detrimental effect on the economy through the immediate currency channel. Rand weakness leads to expected higher inflation, which triggers an interest rate response from the SARB, which after three to four quarters starts negatively affecting local demand growth. Furthermore, fiscal policy then also has to be tightened in an effort to prevent further ratings downgrades by trying to improve debt metrics, with spending cuts and tax increases putting additional pressure on economic growth. So, while financial market investments quickly adjust in response to actual and anticipated negative ratings actions, the effect on economic variables (bar the currency) only becomes evident over time.

As there is significant pressure on the fiscus due to higher interest costs and lower (economic and revenue) growth, higher taxes (personal taxes, fuel levies and, as a last resort, VAT) will be forthcoming, while cutbacks on government expenditure (hopefully on current/goods and services expenditure and not capital expenditure) is inevitable.

Consumer spending will thus come under pressure due to the negative fiscal effect of higher taxes and lower government expenditure on spending power, with real discretionary incomes also eroded by higher inflation and rising interest rates. Furthermore, consumption spending also gets hurt by a cutback on employment by the public and private sectors in response to budget constraints, as well as by the negative wealth effect from falling financial market investments. The middle-to-higher-end consumer (through higher personal taxes and interest rates as well as a negative wealth effect) and the middle-to-lower-end consumer (through higher inflation and VAT as well as lower employment) are adversely affected by this.

Effect on SA financial markets

SA's financial markets already reacted in December 2015 to the combination of negative ratings action from Fitch and S&P, as well as 'Nenegate'. The rand and local bonds sold off aggressively and the equity market weakened. While difficult to gauge precisely how much further potential negative ratings action are already discounted in these markets, different analyses show that a big chunk of a ratings downgrade to junk is already reflected in prices. Below are some examples:

- The real effective rand exchange rate is less than 15% away from its all-time lows reached in the fourth quarter of 2001, after the 1997/98 Asian/emerging market (EM) crisis and the subsequent 2000/01 Dot-com crash, implying that a lot of bad news already seem to be discounted by the local currency. In an analysis of the rand behaviour relative to recent confidence crises in Brazil and Russia (the souring of relations between Russia and the West after the invasion of Ukraine and political instability in Brazil), Bank of America Merrill Lynch comes to the conclusion that the recent rand sell-off has been largely comparable.

- SA's local bond yield premium over US treasuries is now the highest in 13 years, while SA's sovereign bond spreads are also trading at levels in line with a junk rating. Credit default swap spreads (trading at 318 points) indicate that SA's debt is already rated similarly to other sub-investment grade countries.
- Bank of America Merrill Lynch research shows that countries losing IG status typically underperformed global equities by 10% to 15% in the year before the downgrade. The FTSE/JSE All-Share Index (in dollar terms) has underperformed the S&P 500 by 23% since its all-time high on 24 April 2015 and by 11% since its recent high on 4 November 2015.
- SA has not participated in the recovery of EM net portfolio inflows in recent months. During March and April, EMs recovered 77% of the total net portfolio outflows experienced in the second half of 2015, but SA continued to experience outflows in the same period. This is indicative that SA idiosyncratic risk factors have already been factored into the investment decision-making processes of investors.

As far as forced global selling of SA bonds after a junk downgrade is concerned, it should be noted that global benchmark-cognisant bond investors will not necessarily be forced to sell their holdings if one rating agency takes SA's foreign currency rating down to junk level. Bond investors tracking the Citi World Government Bond Index (Citi WGBI), for instance, will only be forced sellers of SA bonds if S&P's and Moody's local currency ratings and not foreign currency ratings are cut to junk. As stated above, the local currency ratings have to be downgraded by three full notches by S&P and two notches by Moody's before South Africa's credit rating would be below investment grade and SA hence removed from the Citi WGBI, triggering a forced selling by benchmark-cognisant investors. Such an outcome is thus still some time off. Foreign investors following the JP Morgan Emerging Market Bond Index (EMBI) benchmark would also not be forced to sell on a junk downgrade, as inclusion in this benchmark is related to issuance and liquidity, and not to quality. However, as the experiences of Brazil and Russia show, markets do react to the headline foreign currency rating when pricing in potential future outflows. Similarly, benchmark-agnostic investors could have other internal risk criteria that could cause them to sell when the foreign currency rating reaches junk level.

It also needs to be highlighted (the obvious) that foreign investors will always consider the relative risk-adjusted attractiveness of the local asset class and the rand when making an investment decision – at weak rand levels and low bond prices there will be times when foreign investors will invest in these asset classes due to attractive prospective return expectations that are deemed to exceed the risk profile attached to these asset classes (probably after a period of rand stabilisation).

In summary, while local asset classes could come under some further downward pressure in the event of a sovereign ratings downgrade, the bulk of the negative effect on the rand, bond yields, equities and listed property probably already lie behind us, while global asset class returns for rand investors will likely benefit from any additional rand sell-off. In essence, Momentum Investments remains of the view that portfolios that are appropriately diversified should cope well with any short-term volatility around negative credit rating action and that a well-constructed asset allocation process within a multi-asset class portfolio framework remains paramount to safeguarding long-term financial wellness for clients. Nevertheless, the company would look to identify potentially lucrative opportunities from any investment price weakness associated with a credit downgrade to add strategic exposures to long-term portfolios at better prices, hence likely increasing portfolio returns for clients in the long run.

Effect on Momentum Investments' outcome-based portfolios

The primary focus of outcome-based investing is to ensure all Momentum Investments' portfolios deliver on their intended outcomes with the highest

probability of success, not losing sight of a strong risk-management focus embedded in portfolio construction and portfolio management. The entire range of Momentum Investments' outcome-based portfolios are constructed with very specific goals in mind, expressed in terms of an investment outcome or objective, an associated term, as well as a predetermined risk budget or risk tolerance. The investment team's portfolio construction process is focused on delivering on the above-mentioned objectives and remains grounded in the belief that a diversification benefit exists in the selection of differentiated asset classes, investment strategies or risk premia and that the implementation, by means of traditional or non-traditional mandates, will increase the likelihood of the company's clients meeting their investment goals
or objectives.

Momentum Investments' portfolios are constructed and positioned to deliver on the robustness that clients have come to expect from an outcome-based investment philosophy and process over appropriate investment horizons. In the current economic and financial climate, the company's portfolios have a well-balanced risk profile that are expected to provide the necessary market-linked exposure to benefit from further market gains, but also provide the necessary shock absorbers to help guard against unexpected negative market developments. Examples of such dynamic structures and strategies include asset allocation flexibility, which, coupled with the investment team's in-house-developed beta management programme, is constructed to quantify excess market returns and aims to identify risks from an asset class perspective.

In light of the above, Momentum Investments maintains a marginal underweight exposure to local growth asset classes, which include local equity and property. However, the company believes that maintaining a diversified strategy exposure in these asset classes will continue to benefit its portfolios despite downgrade risks and associated volatility. This is captured by way of a collection of risk premia identified to deliver alpha over the medium to long term. Momentum Investments has also identified various investment opportunities in the global equity market and has allowed its portfolios to participate in recent currency weakness. Where mandate allows, flexible fixed-income mandates are used where the investment strategies have favoured shorter-dated instruments that are less susceptible to changes in bond yields.